

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petitions	:	
of	:	
WARD LUMBER CO., INC.	:	DETERMINATION
For Redetermination of Deficiencies or for Refund	:	DTA NOS. 823209
of Corporation Franchise Tax under Article 9-A of	:	AND 823163
the Tax Law for the Years 2005, 2006 and 2007.	:	

Petitioner, Ward Lumber Co., Inc., filed petitions for redetermination of deficiencies or for refund of corporation franchise tax under Article 9-A of the Tax Law for the years 2005, 2006 and 2007.

A hearing was held before Thomas C. Sacca, Administrative Law Judge, at the offices of the Division of Tax Appeals, 500 Federal Street, Troy, New York, on June 8, 2010, at 10:30 A.M., with all briefs to be submitted by November 8, 2010, which date commenced the six-month period for issuance of this determination. Petitioner appeared by Hiscock & Barclay, LLP (David G. Burch, Esq., and Kevin R. McAuliffe, Esq., of counsel). The Division of Taxation appeared by Daniel Smirlock, Esq. (Robert Tompkins, Esq., of counsel).

ISSUE

Whether the Division of Taxation properly denied petitioner's claims for qualified empire zone enterprise real property tax credits and tax reduction credits based upon the determination that petitioner, Ward Lumber Co., Inc., did not have a valid business purpose as defined by Tax Law former § 208(9)(o)(1)(D) for its reorganization and that such reorganization was undertaken primarily to gain empire zone tax benefits.

FINDINGS OF FACT¹

1. Petitioner, Ward Lumber Co., Inc., a Delaware corporation, is a building materials manufacturer and supplier formed in December 2001. Prior to its formation, the business presently conducted by petitioner was conducted by a different entity that was incorporated in the State of New York in 1961. The entity incorporated in the State of New York in 1961 was also named Ward Lumber Co., Inc.²

2. Petitioner carries on a fourth-generation family-owned business, which has operated in Jay, New York, for approximately 120 years. Although the business has always been carried on by the Ward family, it has gone through a number of intergenerational transfers over the past 120 years. The Ward family business began in 1890 when its current President Sidney John “Jay” Ward, III’s great-grandfather, Harvey Ward, started a sawmill and cut logs for area farmers. Jay Ward’s great-grandfather had six sons, including Jay Ward’s grandfather, Sidney Ward, Sr. Sidney Ward, Sr. married Agnes, who went on to become a long-time Ward Lumber employee (retiring as bookkeeper in approximately 2005). Sidney, Sr. and Agnes had four children, including two sons involved in the business, Sidney, Jr. (Jay’s father) and Bill Ward, Sr. Sidney Jr. married Janet in the early 1960s, and Janet was employed in the company performing human

¹ Petitioner submitted 45 proposed findings of fact and 13 proposed conclusions of law. In accordance with State Administrative Procedure Act (SAPA) § 307(1), petitioner’s proposed findings of fact have been generally accepted (in some instances after being summarized – *see e.g.* proposed findings of fact 41 through 45) and made a part of the Findings of Fact herein, with the following exceptions:

(i) proposed finding of fact 13 has been rejected as conclusory as it concerns the reasons for petitioner’s business reorganization; and

(ii) proposed findings of fact 27 and 31 have been modified so as to eliminate the last sentences of each as conclusory and not supported by the record; and

(iii) proposed finding of fact 40 has been modified so as to eliminate the portion thereof which sets forth conclusory statements concerning the reasons for petitioner’s business reorganization; and
SAPA does not require rulings to be made upon proposed conclusions of law and none are made herein.

² To maintain clarity, the original Ward Lumber Co., Inc. will be referred to herein as “Ward Lumber I,” and the current Ward Lumber Co., Inc. will be referred to herein as “petitioner.”

resource functions. Upon Sidney, Sr.'s passing in 1970, and continuing through 1972, Sidney, Jr. bought out Bill Ward, Sr.'s shares. Sidney, Jr., owned and operated Ward Lumber I from 1972 through the early 1990s. Until approximately 1988, Sidney, Jr., ran the business as a sole proprietorship and made all the business decisions.

3. In 1988, both Jay and his brother, Jeffrey "Jeff" Allen Ward, joined Ward Lumber I as employees. At that time, Sidney, Jr., Janet, Agnes, Jay and Jeff were the only family members involved in the business. The only shareholders in 1988 were Sidney, Jr. (64%) and Agnes (36%).

4. In 1988, Jay and Jeff did not have any defined titles in Ward Lumber I, but their roles quickly evolved. Jay became more involved in the building materials and retail portion of the business, while Jeff became involved in the lumber manufacturing aspect of the business. Around the end of 1988 or early 1989, Jay became vice-president of retail operations and Jeff became vice-president of lumber manufacturing.

5. In approximately 1990 or 1991, Ward Lumber I was separated into two divisions: the Building Material Division and the Lumber Manufacturing Division. Jay Ward also became increasingly responsible for the day-to-day administrative and executive management of the entire Ward Lumber I. Prior to 1992, as Jay Ward took on growing responsibilities, he created an informal management team comprised of longtime employees with significant responsibilities, including Ward Lumber I's chief financial officer, purchasing manager and plant manager. In 1992, Jay Ward became president of Ward Lumber I, while still managing the Building Material Division. When Jay Ward became president, Jeff Ward was elevated to senior vice-president of Ward Lumber I, with his responsibilities focused on managing the Lumber Manufacturing Division along with Sidney Ward, Jr.

6. Commencing in approximately 1993 or 1994, Agnes Ward, while remaining an employee, began gifting her shares in Ward Lumber I as part of her estate planning. Rick Rolands, Esq., an estate planning attorney, worked with Agnes Ward until approximately 1996 to accomplish her estate goals. Mr. Rolands, and later his associate, Patricia Chevy, Esq., also advised Sidney Ward, Jr., and Janet Ward regarding their estate plans starting in 1996 and through to the present day.

7. Sidney Ward, Jr., retired in early 1996 and Janet Ward retired later in the same year. At the time of their respective retirements, Sidney Ward, Jr., and Janet Ward remained the majority shareholders of Ward Lumber I. At that time, Jay Ward and Jeff Ward were minority shareholders of less than 25 percent each. As part of their retirement plans, Sidney Ward, Jr., and Janet Ward began periodically transferring shares to Jay and Jeff Ward, equally in all cases.

8. Also in 1996, Jay Ward formally created a senior management team, which held regular meetings. The team consisted of all Ward Lumber I's shareholders, the chief financial officer, the purchasing manager, the plant manager and the forester. The shareholders also continued to hold meetings on approximately a quarterly basis. Such meetings were fairly informal, and the goal of the shareholders was generally to reach a consensus decision on all issues.

9. Beginning in 1996, Ward Lumber I began to rapidly grow through acquisitions and expansions of retail locations. In 1996, Ward Lumber I acquired the former Grossman's in Plattsburgh, New York, and hired most of Grossman's former employees. Grossman's had an existing client base already in place, which, it was hoped, would continue to patronize the store after Ward Lumber I acquired it. The decision-making process to purchase the Grossman's location was very abbreviated compared to most of the shareholders' business decisions.

10. In 1998, Ward Lumber I acquired another existing company known as Mountain Log Homes, a manufacturer of log home packages. In 1999, Ward Lumber I acquired yet another existing business known as M.E. Pratt Lumber in New Russia, New York. M.E. Pratt Lumber was a saw mill, and was purchased so that Ward Lumber I could capture M.E. Pratt Lumber's log supply and prevent a competitor from doing so.

11. In 2000, Ward Lumber I began the process of opening a new retail building supply store in Malone, New York. This process required Ward Lumber I to acquire vacant farm land, obtain municipal approvals, excavate and prepare the site for construction, construct the store, outfit the store with necessary fixtures, hire new employees and recruit customers. Unlike Ward Lumber I's purchase of the existing Grossman's location in Plattsburgh, the construction of a new store in Malone came with significant challenges, including the need to hire all new employees, some with no experience in a retail building supply business, to market to new customers and to determine the appropriate mix of products for that market.

12. At this time, Ward Lumber I's shareholders consisted of Sidney Ward, Jr., Janet Ward, Jay Ward and Jeff Ward. The ownership percentages were such that Jay and Jeff Ward owned slightly less than 50 percent combined, with the remaining shares owned by Sidney Ward, Jr., and Janet Ward.

13. Despite its long history, Ward Lumber I was struggling financially prior to its merger into petitioner. While it realized steady profits from 1994 to 1999, Ward Lumber I experienced a rather drastic change in financial condition during the years 2000 and 2001, when it incurred operating losses of approximately \$1.4 million.

14. Several factors contributed to Ward Lumber I's economic downturn and unstable financial condition. Primarily, these factors were: economic distress in the lumber and building

supply industry; mounting competition from Canadian companies; inefficient and outdated equipment in the lumber mill prompting an urgent need to modernize; high employee turnover; rapid rise in production of industrial grade lumber in the mill, which was sold for a loss; and rapid growth and expansion over a five-year period.

15. As financial losses mounted between 2000 and 2001, Ward Lumber I struggled to make its debt service payments with its primary financial lender, NBT Bank, N.A. (NBT). Accordingly, NBT, through its account representative and vice president, and other senior officials, attended frequent meetings with Ward Lumber I to discuss the bank's concerns with the company's financial viability and various options to return the company to profitability. One option frequently suggested by NBT was closing down the mill and liquidating its assets.

16. To avoid closure of the mill, Ward Lumber I attempted to address NBT's concerns by scrutinizing expenses, reducing senior management salaries by eleven percent, eliminating Ward Lumber I's 401(k) matching contributions for employees, changing health insurance plans to lower costs, downsizing staff and reducing hours of operation.

17. Ward Lumber I also considered the option of relocating to the Plattsburgh Air Force Base Park or moving operations outside the State of New York. Moreover, Ward Lumber I actively sought assistance from other organizations and agencies, including the Essex County Industrial Development Agency (Essex County IDA), the Empire State Development Corporation (ESDC) and New York State Energy Research and Development Authority (NYSERDA), as potential funding sources.

18. Because of Ward Lumber I's status as a closely-held family business and its key position as one of the largest employers and business enterprises in Essex County, ESDC, through its regional director, Gregory Caito, became actively involved in efforts to save the

company from closing, and maintaining Ward Lumber I's presence in the northern New York region. Mr. Caito, together with Allen Dunham of the Essex County IDA, adopted a comprehensive approach to alleviate Ward Lumber I's financial crisis and assembled a group of agencies to develop viable alternatives.

19. One option contemplated by the agencies was the separation of the Building Material Division and Lumber Manufacturing Division into separate legal entities with separate management. From a family perspective, the separation was appealing to Jay and Jeff Ward because it would reduce significant family tensions resulting from their differences in opinion as to the management of each division. Another potential benefit of separation was the possibility of dividing up Ward Lumber I's debt among different lenders. Initially, NBT promoted the separation of the divisions because Charter One Bank had expressed an interest in financing the manufacturing division, and NBT was more comfortable in financing the building material division. However, due to underwriting concerns, NBT ultimately determined that any separation would require cross-guarantees, cross-collateralization and cross-default provisions for both entities. As a result, each entity would have to guarantee the debt of the other entity, but neither would have control over the management and operations of the other entity. Moreover, Ward Lumber I's accountant advised against the separation due to the enormous tax liability associated with the severance of the divisions, as well as the increased overhead and administrative costs that would result from running two stand-alone companies. Ultimately, for the foregoing reasons, Ward Lumber I rejected the separation of the divisions into two separate entities.

20. Another option contemplated in 2000 by Ward Lumber I, ESDC and the Essex County IDA was a \$10 million project consisting of construction of a new sawmill and

acquisition of new equipment to improve the mill's efficiency and profitability. Although Charter One Bank had expressed an interest in financing this project with participation from the Essex County IDA, Ward Lumber I ultimately rejected moving forward with the project due to its unwillingness to take on a new \$10 million loan in addition to its existing debt of over \$6 million, as well as Ward Lumber I's inability to provide the necessary 20 to 30 percent equity injection into the project.

21. In 2000, the Essex County IDA invited Ward Lumber I to attend a certain Empire Zones Program Informational Seminar (Empire Zones Seminar) held on October 17, 2000, at the Moriah Business Park in Mineville, New York. At the Empire Zones Seminar, speakers Fred DiMaggio, Director of the Empire Zones Program for Empire State Development, Lois Ketzer from New York State Department of Taxation and Finance, and Marcy Neville, Coordinator for the Moriah, Port Henry, Essex Empire Zone, discussed generally the Empire Zones Program, and how both new businesses and existing businesses became eligible for Empire Zone benefits. Among the items discussed, Mr. DiMaggio stated that an existing business would have to attain a new tax identification number and form a new entity in order to qualify for the benefits available through the Empire Zones Program. Jay Ward attended the Empire Zones Seminar on behalf of Ward Lumber I.

22. Subsequent to the Empire Zones Seminar, Ward Lumber I was strongly encouraged by ESDC and the Essex County IDA at several meetings to pursue the possibility of qualifying for Empire Zone benefits as one of the initiatives to offset Ward Lumber I's continuing financial difficulties.

23. When contemplating the option of moving operations to the Plattsburgh Air Force Base Park in or around 2000, City of Plattsburgh Economic Development representative

Rosemarie Schoonmaker set up a meeting for Ward Lumber I with Mr. McAuliffe on January 5, 2001, to discuss the Empire Zones Program in more detail, and the steps necessary to become certified as an Empire Zone enterprise. Immediately upon leaving that meeting with Ms. Schoonmaker and Mr. McAuliffe, Jay Ward set up a January 12, 2001 meeting at the offices of its accountant, Arthur Place & Company, in Albany, New York.

24. On January 12, 2001, representatives of Ward Lumber I attended the aforementioned meeting with its accountant, Mr. Place, Mr. Rolands and Mr. McAuliffe to discuss, among other things, the formation of a new entity. Due to Ward Lumber I's struggle with financial losses and the family dynamics among its shareholders, Ward Lumber I's accountants and attorneys advised Ward Lumber I of the benefits of incorporating in Delaware. One benefit of incorporating in Delaware included the limited liability afforded shareholders for unpaid wages to employees (as opposed to shareholder personal liability for payroll in New York). Another benefit of incorporating in Delaware discussed at the meeting included "simple majority" voting requirements (as opposed to "super-majority" voting requirements in New York) to foster easier decision-making for management. Moreover, the subject of transition of ownership for estate planning purposes was also generally discussed. Jay Ward's testimony at the hearing generally was consistent with the position that petitioner was formed, among other reasons, to take advantage of a Delaware entity's flexibility in management and estate planning issues and to avail itself of limited shareholder liability for unpaid wages and benefits afforded by Delaware law.

Mr. Ward added as part of his direct testimony that, "part of our bank loaning us more money and sticking with us and going through this whole process was because we were going to get Empire Zone benefits, and those benefits would help pay for some of the debt service." Mr.

Ward further clarified on cross examination that financial stability as a business purpose for the new entity meant that NBT was looking to the cash from the Empire Zone credits as part of financial stability to justify further lending.

25. In or around early 2001, and at the urging of various professional advisors, Jay Ward began his pursuit of Empire Zone benefits. Jay Ward and Ward Lumber I's accounting manager, Cathy Murray, began the process by collaborating with the Essex County IDA and the Moriah-Port Henry Economic Development Zone office to obtain the necessary boundary revision to include Ward Lumber I's building footprint within the Essex County/Moriah-Port Henry Empire Zone. After locating the business within the Zone, and effectuating the merger of the business into a Delaware corporation, petitioner submitted its application for Empire Zone certification, obtained approval of its application from the local board, and ultimately obtained the necessary approval from the New York State Empire Development Office. Petitioner became zone-certified in Essex and Franklin Counties, and received Empire Zone benefits for tax years 2002, 2003 and 2004.

26. Additional recommendations made at an Essex County IDA task force meeting held on May 16, 2001 included pursuit of grants available through ESDC; NYSERDA Energy Smart Loan Fund approval; and credits available under the Empire Zones program. ESDC was able to provide Ward Lumber I with some grant assistance, and Ward Lumber I was approved for a \$350,000.00 NYSERDA Energy Smart Loan on July 24, 2001. Both the ESDC and NYSERDA funds were used to induce NBT to extend additional financing in the amount of \$550,000.00 for a much-needed head rig band saw (Band Saw Loan) to reduce energy consumption in 2001.

27. Despite Ward Lumber I's attempts to cut costs, increase cash flow and seek alternative funding sources, Ward Lumber I defaulted on its loan covenants. Although Ward

Lumber I was current with its payments, Ward Lumber I failed to meet minimum financial requirements respecting its profitability, stockholder equity and debt service coverage ratio.

28. Rather than immediately triggering an acceleration of payments under its loan terms, NBT continued to work with Ward Lumber I and waived Ward Lumber I's noncompliance for fiscal years ended December 31, 2000 and 2001. However, NBT's willingness to continue its lending relationship with Ward Lumber I resulted in increased restrictions and fees. For instance, NBT required unlimited personal guarantees of Jay and Jeff Ward in March 2001, and increased the interest rate on Ward Lumber I's \$3.3 million line of credit from prime minus a quarter to prime plus a quarter. Furthermore, NBT declined to re-amortize the Band Saw Loan over a ten-year period due to a lack of available unencumbered real estate for additional collateral.

29. In 2001, Ward Lumber I's shareholders determined to reorganize into a new Delaware corporation. The shareholders formed a corporation in Delaware known as "Glen Road Lumber, Inc.," which later changed its name to "Ward Lumber Company, Inc." upon the dissolution of Ward Lumber I in New York. Procedurally, the following events took place to create petitioner, and to allow petitioner to carry on Ward Lumber I's business:

- a. On December 14, 2001, the Certificate of Incorporation of petitioner under the original name, Glen Road Lumber, Inc., was filed with the Secretary of State of Delaware.
- b. On December 21, 2001, the Application for Authority of Glen Road Lumber, Inc., to do business in the State of New York as a foreign corporation was filed with the New York State Department of State.
- c. On December 26, 2001, the Certificate of Ownership and Merger of Ward Lumber I (a New York corporation) into Glen Road Lumber, Inc. (a Delaware corporation) pursuant to sections 253 and 103 of the Delaware General Corporation Law was filed with the

Secretary of State of the State of Delaware to actualize the merger of Ward Lumber I and petitioner, effective December 31, 2001, as set forth in a Plan of Merger and Reorganization of the aforementioned entities adopted pursuant to sections 905 and 907(c) of the New York Business Corporation Law, and authorized by unanimous written consent of the board of directors and all shareholders of Ward Lumber I and petitioner on December 4, 2001.

d. On December 31, 2001, a similar Certificate of Merger of Ward Lumber I (a New York corporation) into Glen Road Lumber, Inc. (a Delaware corporation), pursuant to section 907 of the New York Business Corporation Law was filed with the New York State Department of State.

e. On January 10, 2002, a Certificate of Amendment of the Application for Authority of Glen Road Lumber, Inc., was filed with the New York State Department of State to amend the name of the corporation stated in paragraph 1 to "Ward Lumber Company, Inc.," as effectuated by the change of the true corporate name under the laws of the State of Delaware on December 31, 2001.

f. On January 15, 2002, a Certificate of Assumed Name of Ward Lumber Company, Inc., was filed with the New York State Department of State to allow the corporation to operate under the assumed name of "Ward Lumber" in the counties of Clinton, Essex and Franklin.

30. The shareholders of Ward Lumber I and petitioner were the same before and after the merger, and each maintained their percentages of ownership.

31. Thereafter, petitioner was certified under Article 18-B of the General Municipal Law as a Qualified Empire Zone Enterprise (QEZE) in Essex County on March 2, 2002, and in Franklin County on December 30, 2003.

32. In 2001, petitioner, in the name of "Glen Road Lumber, Inc.," had filed a general business corporation franchise tax return, Form CT-4, and a U.S. corporation short-form income tax return, Form 1120-A. The affirmation attached to Form 1120-A included a statement given under penalty of perjury and signed by Jeff Ward that stated:

The purpose of the reorganization was to create a new corporation which would be eligible for economic development incentives and benefits under state law as a certified business in a local economic development zone. These economic development incentives and benefits are of substantial economic and business value to the corporation.

The Form CT-4, Form 1120-A and the attached affirmation were prepared by petitioner's accountant, Arthur Place & Company, P.C., and signed by Jeff Ward. In general, Jay Ward is the company officer who typically reviews and signs tax returns on behalf of petitioner, but he relies heavily on petitioner's accountant to prepare all tax returns.

33. Prior to the merger in December 2001, Ward Lumber I had an overall loss of at least \$700,000.00. After the merger in 2002, the yield from the band saw installation increased from approximately two to three percent to twelve percent, contributing to petitioner's reduction of its overall loss to \$350,000.00. Petitioner began to turn its financial condition around and realized a \$127,000.00 profit in 2003, and an \$829,000.00 profit in 2004. The increase in profits after the merger and the closure of petitioner's component plant afforded the start-up of a livestock equipment company.

34. Due to positive improvements in petitioner's financial condition, NBT continued the extension of petitioner's \$3.3 million revolving line of credit, including a temporary increase of

\$300,000.00 until August 31, 2002. The temporary increase of the line of credit to \$3.6 million required personal limited guarantees of retired shareholders Sidney Ward, Jr., and Janet Ward up to \$500,000.00. Such guarantees were released after petitioner was able to pay off an additional \$500,000.00 in the summer of 2002. Other contributing factors to petitioner's improved financial condition after the merger included cost-reducing initiatives taken by management to address NBT's concerns, as well as receipt of Empire Zone benefits in the amount of \$180,000.00 over a three-year period, from 2002 to 2004.

35. For each of the applicable tax years 2005, 2006 and 2007, petitioner filed a Form CT-3, general business corporation franchise tax return. The returns were prepared by petitioner's accountant, Arthur Place & Company, P.C. Included with the returns were claims for QEZE tax reduction credits, Form CT-604, and claims for QEZE real property tax credits, Form CT-606. For the applicable tax years, petitioner claimed the following amounts as QEZE tax reduction credits: \$312.00 in 2005; \$538.00 in 2006; and \$138.00 in 2007. For the applicable tax years, petitioner claimed the following amounts as QEZE real property tax credits: \$61,408.00 in 2005; \$69,502.00 in 2006; and \$65,681.00 in 2007.

36. Attached to the CT-604 and CT-606 forms for tax years 2005, 2006 and 2007 was a Schedule G Statement outlining, in general, the multiple reasons claimed for the formation of petitioner in 2001, and asserting that petitioner "was formed for valid business purposes" and "was not formed solely to gain Empire Zone benefits."

The Schedule G Statement filed for the years 2005, 2006 and 2007 stated that Ward Lumber I had lost approximately \$1,500,000.00 in 2000 and 2001, due in part to competition and outdated equipment. The statement indicated that Ward Lumber I's lending institution had raised the possibility of shutting down the saw mill and liquidating the operations. Ward Lumber I was

in breach of covenants under the loan documents, and the risk level with respect to the loans had drawn review and oversight by the bank's credit committee and the U.S. Office of the Comptroller of the Currency. According to the statement, Ward Lumber I was faced with three choices: shut down and lay off its employees; build a new mill for over \$10,000,000.00; or develop a plan acceptable to the bank (from which forbearance and additional funds would be needed) to retool the existing facility over time to enable it to compete with the Canadian mills.

The statement further explained that the ESDC, the Essex and Franklin County IDAs and NBT developed a plan that would enable Ward Lumber I to survive and continue its employment, including a staged upgrade of the facility. According to the statement:

ESDC proposed economic development benefits to assist with the re-tooling of the facility, including a grant for the acquisition of a band saw and certain Empire Zone benefits. These Empire Zone benefits would provide needed cash flow to convince forbearance by the bank and additional lending by the bank. In order to remain in business, the business needed an extension of credit from the bank in the approximate amount of \$500,000 to maintain working capital. The bank was willing to lend this money in the event that additional cash flow was made available by reason of the merger into Ward Lumber Company, Inc. Because of the merger into Ward Lumber Company, Inc., and in reliance on ESDC's recommendations, the bank extended an additional \$500,000 on a line of credit to keep the business operating, helped finance (together with an ESDC grant) the acquisition of the band saw, and financed subsequent upgrades. These improvements have increased the facility's yield by 12% and have allowed the facility to remain in operation. Without the merger, these funds would not have been available and the business would have shut down.

Based upon this recommended course of action from ESDC, the use of a merger into a new corporation was examined by the business. At that time, the business was in the midst of succession planning. Because of the advantages of Delaware law with respect to management, franchise taxes and the elimination of certain liabilities if a merger into a Delaware corporation occurred, a decision was made to merge the Predecessor Corporation [Ward Lumber I], a New York corporation, into a new Delaware corporation, Ward Lumber Company, Inc. [petitioner]. Delaware law afforded a better legal structure for the relationship of the shareholders and management through a transition in ownership and management personnel, and allowed for the isolation of certain liabilities.

Because of the merger into Ward Lumber Company, Inc. [petitioner], the business has returned to modest profitability, avoided a shutdown and liquidation by its lender, and maintained its employment of over 100 employees. Ward Lumber Company, Inc. [petitioner], was formed, based upon advice and guidance from ESDC, to reassure the bank of the future prospects of the business, provide additional cash flow available to a lender, and to obtain needed funds from the bank for an upgrade of the facilities. Ward Lumber Company, Inc. [petitioner] was not formed solely to obtain Empire Zone benefits.

The Schedule G Statement was signed by Jay Ward.

37. The Division of Taxation (Division) initially undertook a desk audit of petitioner for the tax year 2005. The auditor sent a letter, dated August 28, 2007, to the attention of petitioner's accounting manager informing her of the 2005 amendments to the Empire Zones Program made by chapters 63 and 161 of the Laws of 2005, which, in part, extend, amend and add new provisions relating to the Empire Zones Program Act, including the additional employment test for a business enterprise first certified prior to August 1, 2002.

38. The August 28, 2007 letter also included a definition of a "valid business purpose" and requested certain documentation from petitioner, which included, among other things: all correspondence between Ward Lumber I, ESDC and NBT Bank in support of the statements in the Schedule G Statement; a copy of the pre-merger plan and all correspondence among Ward Lumber I, ESDC and NBT Bank; documentation from petitioner and NBT Bank respecting an additional \$500,000.00 line of credit extended to petitioner; documentation respecting ESDC's recommendations in support of the \$500,000.00 line of credit; all documentation dated prior to the merger respecting the decision to reincorporate in Delaware including all board of directors minutes that pertain to the reorganization; and documentation respecting any additional benefits, aside from Empire Zone incentives and benefits, expected to be derived from the merger/reorganization.

39. By letter dated December 11, 2007, petitioner, through its attorneys, responded to the auditor's letter, including a number of attachments. The Division responded that although petitioner's response was "somewhat voluminous," it was inadequate and did not substantiate the claim that petitioner was formed for a valid business purpose and not solely to gain Empire Zone tax credits. The auditor sent an additional letter dated January 25, 2008 seeking further clarification and documentation from petitioner.

40. Petitioner, again through its attorneys, responded to the auditor's second request for information by letter dated February 12, 2008. Petitioner's second response declined to provide any of the additional documentation that the auditor requested, claiming that the detailed response of December 11, 2007 and the numerous documents provided therein were more than adequate to establish that petitioner was formed for various valid business purposes.

41. In response, the Division denied petitioner certain QEZE tax benefits beginning in 2005 on the basis that petitioner did not have a valid business purpose. Specifically, by letter dated May 8, 2008, the Division disallowed \$61,720.00 in QEZE real property tax credits and QEZE tax reduction credits claimed by petitioner in 2005 and \$70,040.00 in QEZE real property tax credits and QEZE tax reduction credits claimed by petitioner in 2006. In addition, by letter dated April 14, 2009, the Division disallowed \$65,819.00 in QEZE real property tax credits and QEZE tax reduction credits claimed by petitioner in 2007.

SUMMARY OF THE PARTIES' POSITIONS

42. Petitioner asserts that its formation through the incorporation of Glen Road Lumber, Inc., in Delaware, the merger of Ward Lumber I into Glen Road Lumber, Inc., and the name change back to Ward Lumber Company, Inc. (petitioner) was undertaken for valid business purposes and not solely for the purpose of gaining entitlement to the noted QEZE tax benefits.

Petitioner does not dispute that gaining such tax benefits was one of the aims or motivations in undertaking the reorganization, but claims that there were other overriding purposes motivating the transaction. Petitioner claims that it was formed for multiple valid business purposes relating to the attainment of financial benefits necessary to stabilize its economic position and to remain competitive in existing markets and new emerging markets, while at the same time isolating shareholders from certain liabilities not otherwise precluded by the New York Business Corporation Law (BCL). In particular, petitioner maintains that, initially, the merger resulted in moderate improvements in profitability, with profits continuing to increase in 2003 and 2004. Petitioner states that its cost-cutting measures, increase in yield from the band saw installation, and additional cash flow afforded by the merger and receipt of Empire Zone benefits all contributed to a \$1.9 million increases in profits overall. The additional cash flow also allowed petitioner to expand into a livestock equipment market, which is completely separate from its lumber manufacturing and retail operations. According to petitioner, its economic position changed in a very meaningful way after restructuring. In addition, petitioner points to the benefits of incorporating in Delaware and discontinuing the New York corporation, as other valid business purposes. Specifically, by incorporating in Delaware, petitioner would avoid the personal liability imposed upon the four shareholders for the payment of wages and salaries due and owing to its employees under Business Corporation Law § 630(a) in the event the business became insolvent. Shareholders of a Delaware corporation doing business in New York are not subject to the liability imposed by Business Corporation Law § 630. According to petitioner, eliminating this potential liability was an important factor in deciding to incorporate in Delaware as the financial difficulties and the possibility of NBT discontinuing the line of credit would potentially leave the shareholders facing a large obligation, one that would be especially

financially hard on the retired Sidney and Janet Ward, then residing in Florida. Petitioner also points to the law in New York where certain decisions within the operation of the company require a super majority. Although petitioner admits that none of such circumstances were immediately known to the shareholders of Ward Lumber I at the time the reorganization was undertaken, petitioner opines that it would have been prudent for it to prefer the business law of Delaware in order to provide greater flexibility in the operation of the company and avoid internal situations where a vote could only be accomplished through a division in position between parents or brothers. In sum of the foregoing, petitioner claims, without denying that obtaining QEZE tax benefits was a motivating factor, that petitioner was created for multiple valid business purposes.

43. The Division, in contrast, asserts that to prove entitlement to the QEZE real property tax credits and tax reduction credits, petitioner must show that there was a “valid business purpose,” as defined in Tax Law former § 208(9)(o)(1)(D), for the creation of petitioner such that this entity constituted a “new business.” Specifically, the Division maintains that petitioner must prove that it had a purpose or purposes other than the avoidance or reduction of taxes, that the nontax purpose or purposes for which the reorganization was undertaken constituted the principal motivation for the formation of petitioner, and that such reorganization resulted in a meaningful change in the economic position of the enterprise. In addition, the Division asserts that petitioner must establish that the reorganization was not solely for the purpose of gaining QEZE tax benefits. In disallowing the claimed benefits, the Division notes that the documentary evidence that is contemporaneous to the formation of petitioner, specifically the statement of purpose attached to the 2001 New York and federal tax returns, shows that the reorganization was undertaken solely to gain Empire Zone tax benefits. The Division also points to the Schedule G

Statement attached to petitioner's tax returns for 2005, 2006 and 2007 as evidence that NBT wanted petitioner to obtain QEZE credits as a source of cash before extending additional financing. The Division notes that the merger of Ward Lumber I followed quickly the incorporation of Glen Road Lumber, Inc., which then took the same name, Ward Lumber Co., Inc., and conducted the same business. The Division also notes that the shareholders of Ward Lumber I and petitioner were the same before and after the merger, with the same percentages of ownership. Finally, the Division points out that the reorganization may have benefitted the shareholders by limiting their liability for unpaid wages, simplified shareholder voting in some unspecified situations and unexplained estate planning, but that there is no evidence that the reorganization caused any meaningful economic change in operation or outcomes of petitioner's business.

CONCLUSIONS OF LAW

A. The Economic Development Zone Program³ (the Program), was established by the Legislature in 1986 under Article 18-B of the General Municipal Law. The program sought to stimulate private investment, private business development and create jobs in economically impoverished areas throughout the state (*see* General Municipal Law § 956). Qualified businesses, known as qualified empire zone enterprises, could become certified under Article 18-B of the General Municipal Law, and thus eligible to receive certain tax credits and exemptions upon meeting an employment test directly linked to job creation (Tax Law § 14[a]). In very general terms, with respect to the employment test, the level of tax benefit derived from job creation for a given period was determined by a comparison of the number of jobs a qualified and

³ As of May 15, 2000, the term "Economic Development Zone" was replaced with "Economic Zone" by chapter 63 of the Laws of 2000, which also created Qualified Empire Zone Enterprises.

certified business had in a base period to the number of jobs it had in a particular subsequent period (*see* Tax Law § 14[b][1]).

B. A taxpayer that is a qualified empire zone enterprise (QEZE) and is subject to tax under Article 9-A of the Tax Law “shall be allowed a credit against such tax” for eligible real property taxes and a tax reduction credit (Tax Law § 15[a]; § 16[a]). Under Tax Law § 14(b)(1), a QEZE certified prior to August 1, 2002, with either a base period of zero years or zero employment in the base period passes the employment test only if it qualifies as a new business under Tax Law § 14(j).

C. After the year 2000,⁴ the circumstances that made it possible for an existing business to be able to form a new entity (i.e., reincorporation) so as to qualify for QEZE benefits otherwise unavailable to the existing business (or, if then unavailable, to a lesser degree), was identified by the Legislature as a loophole, referred to by some as “shirt changing.” This practice was deemed inconsistent with the intent of the Program (as described in Conclusion of Law A). Thus, on May 22, 2002, the Legislature amended Tax Law § 14 with respect to businesses created on or after August 1, 2002, by requiring such businesses to qualify as new businesses (Tax Law § 14[j], as added by L 2002, ch 85, pt CC, §§ 1D, 13-a).

This legislative change resulted in a significant increase in the number of businesses being incorporated (or reincorporated) in the period between the May 22, 2002 change in the law and the amended statute’s August 1, 2002 “cutoff” date, after which new business qualification was required. However, this increase in “new” business formation was also perceived to be an additional loophole opportunity, whereby a window period allowed certain taxpayers to gain

⁴ The legislative history of Tax Law former § 14 (L 2000, ch 63, pt GG, § 16[2]) provides that “sections two through seven of this act shall apply to taxable years beginning on or after January 1, 2001.”

entitlement to, or an increase in, QEZE tax benefits. In response, the Legislature again amended the QEZE statutes (*see* Tax Law § 14(j)(4)(B), as added by L 2005, ch 63, pt A, § 5) whereby businesses first certified as eligible to receive QEZE tax benefits prior to August 1, 2002 had to establish that their formation was motivated by a “valid business purpose,” as defined by Tax Law § 208(9)(o)(1)(D). In particular, the business could not have been formed for the sole purpose of gaining QEZE tax benefits. Businesses certified prior to August 1, 2002 were entitled to continue receiving QEZE tax benefits until tax periods beginning on or after January 1, 2005, at which time the valid business purpose test became effective to such businesses.

D. As described above, commencing with tax years beginning on or after January 1, 2005, with respect to the employment test, chapter 161 of the Laws of 2005 amended Tax Law § 14(b)(1) to provide that:

For entities first certified prior to August first, two thousand two, if the entity had a base period of zero years or zero employment in the base period, then the employment test will be met only if the enterprise qualifies as a new business under subdivision (j) of this section.

By virtue of the fact that petitioner was formed, after a reorganization, on December 31, 2001, was thereafter certified eligible to receive QEZE benefits before August 1, 2002, maintained virtually identical ownership and operation to its immediate predecessor (Ward Lumber I), and had zero employees in its base period, petitioner is a business that will meet the employment test only if it meets the new business “valid business purpose” test. Tax Law former § 14(j)(4)(B), provides that a corporation or partnership:

shall not be deemed a new business if it was not formed for a valid business purpose, as such term is defined in [Tax Law § 208(9)(o)(1)(D)] and was formed solely to gain empire zone benefits.

E. Pursuant to Tax Law § 208(9)(o)(1)(D), a “valid business purpose” is as follows:

one or more business purposes, other than the avoidance or reduction of taxation, which alone or in combination constitute the *primary* motivation for some business activity or transaction, which activity or transaction changes in a meaningful way, apart from tax effects, the economic position of the taxpayer. The economic position of the taxpayer includes an increase in the market share of the taxpayer, or the entry by the taxpayer into new business markets (emphasis added).

F. Therefore, petitioner’s status as a new business entitled to the QEZE benefits of real property tax credits and tax reduction credits sought for the years at issue is contingent upon petitioner’s first meeting a two-part standard. First, it must be shown that the reorganization of Ward Lumber I as petitioner (i.e., the formation of petitioner) was undertaken for one or more business purposes, which purposes, alone or together *but apart from and excluding tax avoidance or reduction purposes*, constituted the *primary* motivation for the reorganization the result of which must have meaningfully (and apart from tax considerations) changed the economic position of the business. Second, it must also be shown that the reorganization was not undertaken solely in order to gain QEZE benefits. Since the QEZE benefits referred to are undeniably tax benefits (i.e., real property tax credits and tax reduction credits), it follows that such tax benefit impact applies to both parts of the foregoing two-part standard for entitlement to QEZE tax benefits. That is, in order to be entitled to the QEZE tax benefits at issue, obtaining such QEZE tax benefits cannot have been the *sole* purpose for undertaking the reorganization and, further, gaining the benefit of tax avoidance or reduction, either as to taxes in general or in particular as the result of realizing such QEZE tax benefits, cannot have been the *primary* purpose for undertaking the reorganization.

G. Petitioner recognizes the standard for eligibility as a two-fold test, and the burden of establishing that petitioner was formed for valid business purposes. However, petitioner claims that in order for the Division to determine that an entity failed the employment test under Tax Law § 14, the Division must make a finding that the entity was formed solely to gain empire zone benefits. Petitioner's position erroneously seeks to place the burden of proof on the Division, in contravention of Tax Law § 1089(e) and 20 NYCRR 3000.15(d)(5). It is well established that taxpayers bear the burden of proving entitlement to the tax credits and exemptions they seek (*see e.g. Matter of Brookfield Power New York Corp.*, Tax Appeals Tribunal, November 10, 2010). Therefore, to establish entitlement to the QEZE tax benefits, petitioner is required to meet both parts of the two-part standard by establishing that the reorganization was not undertaken solely in order to gain QEZE benefits and, further, that the reorganization was not undertaken primarily to gain the benefit of tax reduction or avoidance (including therein tax reduction as the result of gaining QEZE benefits, which are clearly tax benefits). Review of the entire record supports the conclusion that petitioner has not established entitlement to the QEZE tax benefits at issue. The evidence shows that at the time of the reorganization, tax avoidance or reduction based on entitlement to the QEZE tax benefits, as opposed to the other claimed business purposes, was the primary motivation for reorganization.

H. In examining the record to determine whether a valid business purpose existed at the time of the reorganization, as specifically defined and separate from securing tax benefits, one must look at the circumstances existing at the time the decision to reorganize was made. The Division states in its brief that there was no valid business purpose for the reorganization of Ward Lumber I into petitioner apart from maximizing QEZE tax benefits. This position is based on the sworn statement of purpose attached to petitioner's 2001 tax returns, which speaks only of

maximizing such benefits. The Division contends that the statement of purpose is the only contemporaneous documentation relating to the reorganization and thus is the most reliable indication of the purpose for the reorganization. It is true that the statement of purpose speaks only to maximizing the available QEZE tax benefits to be derived from the reorganization. For its part, petitioner admits that obtaining QEZE tax benefits was one of the purposes considered in its decision to reorganize. At the same time, however, petitioner maintains that there existed several reasons and purposes apart from the QEZE tax benefits for deciding to reorganize. Ultimately, then, the question to be considered is whether it is reasonable to accept that the various stated business reasons for reorganization would have resulted in the reorganization of Ward Lumber I as petitioner *absent* the availability of the QEZE tax benefits resulting therefrom.

I. While not necessarily dispositive on the issue of valid business purpose as that term is defined per Tax Law former § 208(9)(o)(1)(D), the statement of purpose attached to petitioner's 2001 tax return is clearly a significant factor supporting QEZE tax benefits as the sole purpose for the reorganization. It is the only contemporaneous documentation in the record concerning the reasons for reorganization. In addition, it is a sworn statement of purpose prepared by petitioner's accountants. This same accounting firm attended the January 12, 2001 meeting in which the benefits of incorporating in Delaware were discussed, yet in preparing the statement of purpose, the accountants included qualifying for the QEZE tax benefits as the only reason for the reorganization. In addition, the testimony and other documents in the record establish that petitioner was in serious financial difficulties, and the QEZE tax benefits were the cash infusion required by NBT to continue financing the business operation.

In 2000 and 2001, Ward Lumber I was struggling financially and had incurred losses of approximately \$1.4 million. Due to the financial losses, petitioner was having difficulty making

its debt service payments to NBT, its primary financial lender. During several meetings in which NBT expressed its concerns regarding the company's financial viability and various options to return Ward Lumber I to profitability, NBT suggested that the mill be closed and the operations liquidated. Despite Ward Lumber I's efforts to address NBT's concerns by attempting to cut costs, increase cash flow and seek alternative funding sources, the company defaulted on its loan covenants. Although able to make its loan payments, Ward Lumber I failed to meet minimum financial requirements respecting its profitability, stockholder equity and debt service coverage ratio. Ward Lumber I was then faced with three choices: close the facility; build a new mill; or develop a plan to retool the existing facility acceptable to NBT to obtain forbearance from its default on the loan covenants and additional funds. Although NBT could have demanded an acceleration of payments under its loan terms, it decided instead to continue to work with Ward Lumber I. NBT was willing to lend to Ward Lumber I \$500,000.00 in order for the business to continue operating, to assist, along with an ESDC grant, the financing of the new band saw and to finance subsequent upgrades, if an additional cash flow was developed. This cash flow was the QEZE tax benefits.

This conclusion is further supported by Jay Ward's testimony at the hearing and the Schedule G Statement filed for the years 2005, 2006 and 2007. Although Jay Ward did testify as to the Delaware shareholder advantages being considered during the reorganization process, it was clear from his testimony that pursuing the QEZE tax credits was essential to NBT continuing to finance the business operation. Mr. Ward emphasized that NBT agreed to not accelerate the loan payments and to continue to loan money to petitioner because the business was going to obtain the Empire Zone benefits, and the benefits would help pay for some of the debt service. Mr. Ward added that achieving financial stability as a business purpose meant that NBT was

looking to the cash from the QEZE tax credits as part of financial stability to justify further lending. According to the Schedule G Statement, the economic zone benefits “would provide needed cash flow to convince forbearance by the bank and additional lending by the bank.” The Schedule G Statement further acknowledged that for petitioner to remain in business, the business needed an extension of credit from NBT in the amount of \$500,000.00. NBT was willing to lend this amount to petitioner in the event that additional cash flow was made available by reason of the reorganization, which was necessary for petitioner to qualify for the QEZE tax benefits. Without the reorganization, the Schedule G Statement states that the funds from NBT would not have been made available and the petitioner would have closed.

J. Petitioner points to the benefits of incorporating in Delaware and discontinuing the New York corporation, as other valid business purposes. Specifically, by incorporating in Delaware, petitioner would avoid the personal liability imposed upon the four shareholders for the payment of wages and salaries due and owing to its employees under Business Corporation Law § 630(a) in the event the business became insolvent. According to petitioner, eliminating this potential liability was an important factor in deciding to incorporate in Delaware. Petitioner also points to the law in New York where certain situations within the operation of the company require a super majority, although petitioner admits that none of such circumstances were immediately known to the shareholders of Ward Lumber I at the time the reorganization was undertaken. In sum of the foregoing, petitioner claims, without denying that obtaining QEZE tax benefits was a motivating factor, that petitioner was created for multiple valid business purposes.

Although the other reasons put forth by petitioner for the reorganization explain why Delaware was chosen as the state of incorporation, these considerations, as opposed to the clearly stated purpose of gaining the QEZE tax benefits, have not been shown to be the primary

motivation for the reorganization. Petitioner admittedly was not aware of the circumstances at the time of reorganization surrounding the need for a super majority and thus this aspect of New York and Delaware laws had no impact on its decision. As to the avoidance of personal liability upon shareholders for the payment of salaries due and owing to its employees in the event the business became insolvent, and some estate planning advantages, these are certainly benefits to the shareholders of petitioner, but the record is devoid of any evidence as to how they changed in a meaningful way the economic position of petitioner, as required by Tax Law §208(9)(o)(1)(D). While petitioner's business grew and improved, there is no apparent connection between such growth, or change in market share or any like economic consequence, which may be said to have resulted from the reorganization itself. In view of these circumstances, it cannot be concluded that any of the post-reorganization reasons for having undertaken the reorganization, as advanced in the face of audit inquiry, either alone or in combination constituted the primary purpose for having entered into the reorganization, or that such reorganization caused or resulted in a meaningful change in petitioner's economic position. The circumstances and evidence clearly support the conclusion that the reorganization was undertaken for the primary purpose of allowing petitioner to gain the QEZE tax benefits, with any other potential benefits neither borne out as significant nor anything other than considerations ancillary to gaining such QEZE benefits. Under this conclusion, Ward Lumber Company, Inc., cannot qualify as a new business and thus the Division properly disallowed the QEZE tax benefits claimed by petitioner.

K. The petition of Ward Lumber Co., Inc., is hereby denied, and the Division of Taxation's letters of denial dated May 8, 2008 and April 14, 2009 are sustained.

DATED: Troy, New York
April 28, 2011

/s/ Thomas C. Sacca
ADMINISTRATIVE LAW JUDGE